Summary

Against the backdrop of a re-pricing of US rates a number of Emerging Markets central banks this week reviewed their monetary policies. Prominence was given to the 50bps of hikes implemented by Indonesia and Brazil, but the main message from Emerging Markets last week was in fact that everything is cool. Russia, Malaysia, Chile, South Korea, Peru and Mexico's central banks all left rates unchanged. Hence the notion that rate changes in the US and other developed markets dictate policy rates in Emerging Markets was shown, once more, to be out of touch with reality in the majority of Emerging Markets countries. Monetary policy is mainly determined by growth and inflation, neither of which have changed a great deal. Only those countries that have been less than prudent with their macroeconomic management now find themselves scrambling to assert their relative policy independence.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	943		2.81%
MSCI FM	541		1.62%
GBI-GD	6.48%		1.07%
ELMI+	4.19%		0.89%
EMBI GD	5.83%	320 bps	-0.08%
EMBI GD IG	4.87%	225 bps	-0.07%
EMBI GD HY	9.32%	689 bps	-0.11%
CEMBI BD	5.67%	352 bps	0.28%
CEMBI BD HG	4.80%	262 bps	0.26%
CEMBI BD HY	7.63%	553 bps	-0.13%

Global backdrop	Index level/yield/ FX rate/price	1 week change
S&P 500	1,675	2.69%
VIX Index	13.94	-6.38%
5 year UST	1.43%	-7 bps
10 year UST	2.53%	-21 bps
10 year Bund	1.55%	-17 bps
EURUSD	1.3017	1.44%
USDJPY	99.16	-2.06%
Brent	$109	0.56%
Copper	$323	1.46%
Gold	$1283	3.55%

Emerging Markets

The following story should be familiar. A change in Fed rhetoric triggers a re-pricing of US treasuries (alternatively we could have said that US growth fell or that commodity prices declined, take your pick it doesn't really matter). So-called 'risk free' assets are now suddenly more attractive than 'risky' Emerging Markets assets. Investors ship out en masse. Liquidity collapses to zero, because there are no buyers. The selling pushes Emerging Markets currencies sharply lower and local bond yields spike. The combination of weaker currencies and higher domestic yields is toxic for fundamentals – classic Soros reflexivity. Inflation immediately rises due to FX pass-through and economies weaken with frightening speed as financial conditions tighten dramatically. Central banks are forced to hike into the coming recession. Collapsing growth exposes major fiscal weaknesses and central banks print to keep core government functions going. But money printing only fuels the inflationary fires and currency depreciation goes exponential. Capital flight picks up. Central banks burn reserves to stem the exodus, but soon run out of ammunition. Unable now to service external debt obligations due to the loss of reserves sovereign default risk increases sharply. The choice is now suddenly stark: Surrender economic and de facto political autonomy to the IMF, or default to face capital market purgatory until the next time US interest rates decline (or US growth rises or commodity prices go up, take your pick it doesn't really matter).

The biggest problem with this narrative of Emerging Markets is that so many investors still believe it. It is in fact nearly 25 years out of date. Let us briefly remind ourselves of the current economic reality in Emerging Markets. Emerging Markets governments today mainly finance themselves from domestic sources, such as local pension funds, not from foreign sources, and particularly not from fast money. Indeed, today it is chiefly corporates that borrow externally, although corporates also get four times more financing from local sources than from global capital markets. A fresh study issued by J P Morgan in the past week shows that Emerging Markets corporates currently represents 86% of the total Emerging Market (Dollar) debt supply compared to 20% in 2000. It is also worth remembering that Emerging Markets have been able to sustain growth rates approximately 15 times faster than developed economies during the crisis of the past five years (6% real GDP growth versus 0.4% on average in Europe/US/Japan). This is because Emerging Markets growth is mainly due to domestic demand, which has become the main driver, as policy conditions in Emerging Markets are largely sound. Most Emerging Markets central banks today target low to moderate inflation, while fiscal authorities have successfully kept public debt flat around the 33% of GDP level throughout the global crisis. Emerging Markets central banks today now control 80% of the world's foreign exchange reserves, which means that they entirely control global currency markets. Indeed, G20 has replaced G7 as the world's main decision-making body in global economic affairs precisely due to this fact. Today it is Emerging Markets which finance the IMF, rather than the other way around.

Having said all that, it is silly to argue that Emerging Markets are a flawlessly managed haven for investment. This would be merely to replace one myth – that Emerging Markets are a bunch of toxic basket cases – with another. There is risk in every market, including Emerging Markets. Indeed, one of the most important (but ultimately attractive) characteristics of Emerging Markets is their enormous diversity. Uruguay is as different from Argentina as Sweden is from Greece. The contrast between South Korea and India is greater than that

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Emerging Markets

between Japan and Portugal. Tanzania is profoundly different from its neighbour Rwanda, while Colombia bears almost no resemblance to its 'Gran Colombia' sister of Venezuela. Thailand is next to Myanmar, but might as well be on a different planet in terms of its economic and political fundamentals. And all of them offer interesting potential investment opportunities.

As global sentiment continued to gradually regain a measure of rationality following the re-pricing of US interest rates since late May and June, the past week offered an excellent illustration of the diversity within Emerging Markets. Mexico, Peru, Indonesia, Brazil, Chile, Malaysia, South Korea, and Russia all had important monetary policy decisions over the past week. Brazil hiked interest rates by another 50bps to 8.5%, forced into this action despite weaker growth. This was because inflation has risen above the central bank's target range. We expect the central bank to continue to raise rates in the coming meetings and for inflation to return to the target range very slowly. Indonesia also raised rates by 50bps, forced to do so by a challenging policy constellation, which until recently sought to incongruously preserve a nominal FX target, an absolute level of FX reserves, and strong domestic demand. Like Brazil, Indonesia has more work to do to restore macroeconomic equilibrium, but is ultimately likely to do so due to the adverse political ramifications of any alternative. In contrast, Mexico, Peru, Chile, South Korea, Russia, and Malaysia left policy rates unchanged. And in doing so they are in fact far more representative of Emerging Markets in general than Brazil and Indonesia. Policy is generally very prudent. Inflation is under control. Growth is robust subject only to the normal shocks imparted from exogenous sources. But normalcy is boring.

Global backdrop

Global market sentiment continues to be held hostage to the Federal Reserve's so far bungled efforts to explain why it is tapering quantitative easing (QE), but not raising interest rates. Still, last week there were signs that the rationale for scaling back QE – that its effectiveness as a tool of policy is becoming more marginal and that this does not imply anything whatsoever for rates – is perhaps beginning to get through to the market. The difficulty the Fed has, however, is that it has also conditioned the pace of QE tapering on the outturn of the data. Not only does this suggest that the marginal effectiveness of QE is quite changeable depending on the data, it also clearly creates a correlation between expectations for QE and rates, because the outlook for rates too depends on the data, obviously. It is therefore likely that the market will continue to price in a high correlation between QE tapering and future rate hikes. Having said that, Fed Funds are now pricing the first hike to occur in Q1 2015, while the US swaps curve prices four hikes by June 2015. We think the risk is for fewer hikes, later. As such, both the short end and the belly of the curve now look well anchored. In contrast, we believe that the very flat term structure is a concern. A non-inflationary recovery in the United States is by no means a given, even if inflation risks are still some quarters away. We are now in a world of greater volatility, not just in rates, but also in stock markets, which in the past week illustrated precisely this sensitivity, when they reacted very strongly to the perceived dovish message from Federal Reserve Chairman Ben Bernanke. We do not think investors should be overly worried about volatility. Volatility is given too much prominence as a gauge of risk; prices often move far in excess of fundamentals, driven by a range of influences from fads, herd behaviour, and media frenzies. Of course, the alternative of actually doing research to measure risk would be far more costly than just using price volatility. Perhaps that is why the world of finance is so touchingly loyal to such a silly idea.

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